BEFORE THE TENNESSEE REGULATORY AUTHORITY
NASHVILLE, TENNESSEE

REC'D TN REGULATORY AUTH.

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OFFICE OF THE EXECUTIVE SECRETARY

IN RE: TARIFF FILINGS BY LOCAL EXCHANGE COMPANIES TO COMPLY WITH FCC ORDER 96-439 CONCERNING THE RECLASSIFICATION OF PAY TELEPHONES

DOCKET NO. 97-00409

TENNESSEE PAYPHONE OWNERS ASSOCIATION'S MOTION TO FILE REPLY BRIEF

The Tennessee Payphone Owner's Association ("TPOA") has filed a Petition for Clarification and Reconsideration in the above-captioned proceeding. BellSouth has filed a Response opposing, in part, TPOA's Petition, but agreeing not to impose Directory Assistance charges on payphone providers at this time. TPOA now seeks permission, pursuant to TRA Rule 1220-1-2-.06, to file the attached reply brief.[1]

In support of this motion, TPOA submits that (1) the TRA typically allows the party carrying the burden of persuasion to file a reply brief; (2) TPOA's reply explains and corrects a computational error made in TPOA's Petition, and (3) the filing of this reply will not cause any delay in this proceeding.

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1 Rule 1220-1-2-.06 applies to "preliminary motions" not to a Petition to Reconsider. But since Rule 1220-1-2-.20 on Petitions to Reconsider does not address, one way or the other, the filing of replies, TPOA relies on Rule 1220-1-2-.06 as being closely analogous.

Therefore, TPOA asks that this reply brief be accepted.

Respectfully submitted,

BOULT, CUMMINGS, CONNERS & BERRY, PLC

By:______________________________

Henry Walker
414 Union Street, Suite 1600
P.O. Box 198062
Nashville, TN 37219
(615) 252-2363
Attorney for Tennessee Payphone Owners Association

BEFORE THE TENNESSEE REGULATORY AUTHORITY
NASHVILLE, TENNESSEE

IN RE: TARIFF FILINGS BY LOCAL EXCHANGE COMPANIES TO COMPLY WITH FCC ORDER 96-439 CONCERNING THE RECLASSIFICATION OF PAY TELEPHONES

DOCKET NO. 97-00409

REPLY OF TENNESSEE PAYPHONE OWNERS ASSOCIATION

The Tennessee Payphone Owners Association ("TPOA") submits the following reply to the Response filed by BellSouth Telecommunications, Inc. ("BellSouth") in opposition to TPOA's Petition for Clarification and Reconsideration.

I. Touch-Tone

BellSouth's "cost-based" payphone tariff includes a charge of $3.00-a-month for Touch-Tone service. This fictitious "cost" effectively increases by 20% the PTAS rate set by the Tennessee Regulatory Authority in the agency's Interim Order, issued February 1, 2000.

On this much, the parties apparently agree: (1) BellSouth bears the burden of proof in this proceeding to demonstrate that its payphone tariffs are consistent with federal and state law; (2) Touch-Tone functionality, like measured local service, is an optional feature available to all end-users but a necessary service for payphone providers;(3) there is no additional cost to provide Touch-Tone functionality; and, (4) there is no evidence in the record and no finding in the Interim Order that BellSouth's Touch-Tone rate is consistent with federal and state law.

Based on these agreed premises, TPOA submits that BellSouth's revised payphone tariffs should include only those charges which were approved by the Authority in the Interim Order and that BellSouth's charges for Touch-Tone functionality should be removed from the payphone tariff.

In response to TPOA's Petition, BellSouth raises one procedural argument and one legal issue. Procedurally, BellSouth claims that it is too late now for TPOA to submit "new evidence" on the Touch-Tone issue. Response at 2. But TPOA does not seek to present any evidence. It is BellSouth's burden, not TPOA's, to demonstrate that BellSouth's payphone rates are consistent with federal and state law. Since BellSouth presented no such evidence at the hearing, TPOA's Petition questions whether BellSouth is entitled to continue charging payphone owners for Touch-Tone functionality.

Legally, BellSouth argues that Touch-Tone charges to payphone providers are not at issue in this proceeding since the FCC has stated that the federal guidelines for payphone rates do not apply to services, such as Touch-Tone, that "are only incidental to payphone services." See paragraph 18 of the FCC's "Waiver Order," cited in footnote 2 of BellSouth's brief. [1] Because of that language, TPOA accepts, for now, that the New Services test does not apply to Touch-Tone service. Therefore, TPOA challenges the Touch-Tone charges based, not on the FCC's New Services test, but on Section 276 of the federal Telecommunications Act, which

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[1] TPOA believes that the FCC's position on this issue may be clarified when the agency issues an order in the "Wisconsin" docket, in which the FCC itself is setting intrastate payphone rates for four Wisconsin LECs. In the order, the agency is expected to address which payphone rates must meet the "New Services" test and thereby resolve an issue that has arisen in a number of state payphone proceedings.

"prohibits payphone rates from including subsidies to or from other telecommunications services" (TRA *Initial Order*, at 16). A $3.00 charge for Touch-Tone functionality is clearly intended to subsidize other telephone services. Furthermore, Section 276 is intended to "promote the widespread deployment of payphone services." *Id.*, at 15. BellSouth's Touch-Tone charge unnecessarily increases the cost of payphone service and discourages the deployment of payphone services. Finally, the Touch-Tone charge violates T.C.A. § 65-5-208(c) which prohibits "cross subsidization" of one telephone service by other services. Each of these issues were raised in TPOA's Petition. None is addressed in BellSouth's Response.

II. Directory Assistance

The parties agree that, despite the language in BellSouth's revised payphone tariffs, the company will not begin charging payphone providers for directory assistance until after the TRA has specifically approved such charges. Therefore, TPOA's request for clarification or reconsideration of this issue is apparently moot.

III. Allocation of Interstate Costs

There is no question that the TRA must separate BellSouth's intrastate and interstate costs in order to establish "cost-based" intrastate payphone rates. The question at issue is how to accomplish that separation.

TPOA's expert witness, Don Wood, testified that the proper method of fixing cost-based, intrastate rates in this proceeding is to (1) calculate the total, unseparated cost of providing payphone service, (2) deduct the interstate revenue which the carrier receives for that service, and (3) establish intrastate rates to cover the remaining costs. Wood, direct testimony at 21.

Similarly, the FCC held in the *Wisconsin* decision that in order to avoid the "double recovery" of costs, intrastate payphone rates must be fixed after "taking into account other sources of revenue,(*i.e.*, SLC/EUCL, PICC and CCL access charges) that are used to recover the costs of the facilities involved." Paragraph 12. No one has challenged that holding in the *Wisconsin* Order.

Finally, the Massachusetts Department of Telecommunications and Energy held recently that the Department "will include revenues that Verizon receives from the SLC" in determining whether payphone charges are properly set to recover the TSLRIC of payphone service. Massachusetts Order at 17. (A copy of the order is attached to TPOA's Petition for Clarification and Reconsideration.)

Each of these three sources is saying the same thing: the only proper method to separate interstate and intrastate costs in this proceeding is todeduct (*ie.,* "take into account") BellSouth's EUCL/SLC revenue from BellSouth's total cost-of-service and set intrastate PTAS rates based on the remaining (residual) costs. In the absence of a jurisdictionally separated cost study, this procedure is the best method of separating intrastate and interstate costs and the only method that insures BellSouth will not recover the same costs twice. No party to this proceeding has suggested any other method of separating BellSouth'sinterstate costs.

In response to TPOA's arguments, BellSouth contends that the TRA "excluded all interstate costs" from this proceeding by allocating 25% of BellSouth's payphone costs to the interstate jurisdiction and, therefore, the final intrastate PTAS rate "did not recover any such costs." BellSouth Response, at 8. BellSouth acknowledges that the EUCL/SLC charge is intended to recover interstate loop cots but insists it cannot be used to approximate those costs. *Id.,* at 7.

According to BellSouth, TPOA's proposal to use the EUCL/SLC charge as a surrogate for BellSouth's interstate costs "seeks to use a portion of [TPOA's] EUCL payments to offset intrastate costs . . . in violation of federal law. *Id.*

BellSouth's claim is both a familiar argument and, following a series regulatory and judicial decisions in the late 1980s and early 1990s, a thoroughly discredited one. It is now well established that, in the absence of a jurisdictionally separated cost study, state commissions are free to separate interstate and intrastate costs by using the carrier's interstate revenue as a proxy for the carrier's interstate costs. *Crockett Telephone v. FCC*, 963 F.2d 1564 (D.C. Cir. 1992) This is the method recommended by Mr. Wood, the procedure referred to by the FCC in the *Wisconsin Order*, and the method described in the Massachusetts payphone decision. It is a company-specific allocation method that is more accurate than the industry-average allocation figure used in the Interim Order.

As all parties agree, the forward looking cost study submitted by BellSouth in this case shows "unseparated" costs. Therefore, for both jurisdictional and Constitutional reasons, the agency must find some method of separating BellSouth's interstate and intrastate costs. The best way to do that is to use, not an industry average, but the same allocation process used by BellSouth in establishing the carrier's EUCL/SCL charge — which is calculated to recover the carrier's interstate revenue requirement associated with the local loop.[2] Under this proposal, the

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[2] According to the FCC, BellSouth's EUCL charge "serves the purpose of recovering regulated [loop] costs associated with payphones." (Quoted by BellSouth witness Sandy Sanders, Rebuttal at 7.) The charge is calculated by "dividing one-twelfth of [BellSouth's] project annual revenue requirement for the End User Common Line element by the projected average number of local exchange service subscriber lines in use during such annual period . . ." 47 C.F.R. § 69.152. In other words, the EUC charge is based on BellSouth's interstate loop costs divided among the company's projected number of access lines. Any under-or-over recovery of (continued...)

sum of BellSouth's interstate and intrastate payphone revenue should be equal to the company's total costs, as reflected on the carrier's books, of providing a payphone line.

In contrast, the allocation procedure adopted in the Interim Order does not identify all of BellSouth's interstate costs. The TRA's method allows BellSouth to collect $21.63 in interstate and intrastate revenue to cover $18.38 in costs (see "Correction" below), which is exactly the kind of "double recovery" the Authority's allocation procedure is intended to prevent. "No company has a legal or equitable right to obtain more than its full costs." *See, MTS and SATS Market Structure*, 103 F.C.C. 2d 1017, 1027 (1986) and *Mid-Plains Telephone Company*, 5 F.C.C.R. 7050 (1990); see also *Crockett Telephone,supra, at 1572* and in *In Re: Earnings of Alltel Tennessee, Inc. et al.*, Tennessee Public Service Commission Docket U-88-7772, March 17, 1989, affirmed in *Crockett Telephone*, *supra.* A copy of the *Alltel* Order is attached.

As the Tennessee Public Service Commission wrote in *Alltel,* supra, at 21-22:

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> The purpose of ratemaking is to set rates to cover costs. Those costs are not pulled from the air; they are recorded in the carrier's books. No matter how those costs are divided between the state and federal jurisdictions . . . the sum of a carrier's interstate and intrastate revenue requirements cannot be more than the actual costs shown on the carrier's books. No carrier has the right to charge customers for expenses that don't exist . . . [The Commission] has both the right and the duty to prevent carriers from creating phony 'costs' by assigning some expenses to both jurisdictions.

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[2](...continued)
the costs recovered through the EUCL/SLC charge would presumably be attributed to an error in estimating the projected number of access lines and would be relatively insignificant. Therefore, the EUCL/SLC charge accurately approximates that portion of the local loop cost which BellSouth allocates to the interstate jurisdiction. (As explained in the Petition, TPOA has not taken into account the PIC charge because that element is being phased out by the FCC.)

The only way to prevent double recovery in this case is, as Mr. Wood, the FCC, and the Massachusetts commission all recognized, is to deduct the EUCL/SLC charge from BellSouth's total costs and then establish intrastate rates to cover the remaining costs. Therefore, TPOA again urges the TRA to reconsider its decision concerning the separation of interstate and intrastate costs and to fix rates based on the methodology recommended by TPOA.

IV. Correction

There is a computation error in footnote 7 of TPOA's Petition for Clarification and Reconsideration. If the TRA deducts the EUCL/SLC charge from BellSouth's total costs, the resulting intrastate PTAS rate would be $10.53, not $6.60 as stated in the Petition. TPOA apologizes for this error.

The mistake occurred because counsel for TPOA deducted the $7.85 SLC/EUCL charge from BellSouth's total, direct costs ($12.25) as shown in the TSLRIC cost study. That is incorrect. One must first determine BellSouth's total cost-of-service, both interstate and intrastate, including a reasonable overhead allocation. Therefore, multiplying the $12.25 in direct costs by 1.50 (overhead allocation) produces a total cost of service of $18.38. Then one subtracts the $7.85 EUCL/SLC charge (which represents loop costs, both direct and overhead, allocated to the interstate jurisdiction [3]) to arrive at an intrastate PTAS line rate of $10.53.

V. Conclusion

For these reasons, TPOA asks that the Authority clarify and amend the Interim Order to (1) order BellSouth to remove from the revised payphone tariff any charges for Touch-

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[3] See footnote 3, *supra*.

Tone service; (2) remove charges for Directory Assistance; and (3) recalculate the intrastate PTAS line rate in accordance with the methodology recommended by TPOA's expert witness.

Respectfully submitted,

BOULT, CUMMINGS, CONNERS & BERRY, PLC

By:______________________________

Henry Walker
414 Union Street, Suite 1600
P.O. Box 198062
Nashville, TN 37219
(615) 252-2363
Attorney for Tennessee Payphone Owners Association

CERTIFICATE OF SERVICE

I hereby certify that on the 9 day of March, 2001 a copy of the foregoing document was served on the parties of record, via U.S. Mail, addressed as follows:

Richard Collier, Esq.
Tennessee Regulatory Authority
460 James Robertson Parkway
Nashville, Tennessee 37243-0505

T.G. Pappas, Esquire
Bass, Berry & Sims
2700 First American Center
Nashville, Tennessee 37219-8888

James Wright, Esquire
United Telephone-Southeast
14111 Capitol Blvd.
Wake Forest, NC 27587

Tim Phillips, Esq.
Consumer Advocate Division of the Attorney General's Office
426 5th Ave., North, 2nd Floor
Nashville, TN 37243

Richard Tettlebaum, Esq.
Citizens Telecom
6905 Rockledge Dr.
Suite 600
Bethesda, MD 20817

Guilford F. Thornton, Jr., Esq.
Stokes Bartholomew Evans & Petree
Sun Trust Center
424 Church St., Suite 2800
Nashville, TN37219-2386

Guy M. Hicks, Esquire
BellSouth Telecommunications, Inc.
Suite 2101
333 Commerce Street
Nashville, Tennessee 37201-3300

Jon Hastings, Esquire
Boult, Cummings, Conners & Berry
414 Union Street, Suite 1600
Nashville, Tennessee 37219-8062

Henry Walker

TENNESSEE PUBLIC SERVICE COMMISSION
460 JAMES ROBERTSON PARKWAY
NASHVILLE, TENNESSEE 37219

TRANSMITTAL LETTER

I HAVE ATTACHED A COPY OF A RECENT COMMISSION ORDER WHICH IS BEING SENT TO PARTIES OF RECORD AND/OR OTHER INTERESTED PARTIES.

PAUL ALLEN
EXECUTIVE DIRECTOR

BEFORE THE TENNESSEE PUBLIC SERVICE COMMISSION
March 17, 1989 Nashville, Tennessee

IN RE: EARNINGS OF ALLTEL TENNESSEE, INC., CROCKETT TELEPHONE COMPANY, PEOPLES TELEPHONE COMPANY, AND WEST TENNESSEE TELEPHONE COMPANY

DOCKET NO. U-88-7572

ORDER

This matter is before the Commission as a result of a Show Cause Order issued by the agency on June 23, 1988, directing the four defendants — Alltel, Crockett, Peoples, and West Tennessee telephone companies — to reduce their intrastate earnings to a just and reasonable level. A copy of the Show Cause Order is attached. See Appendix.

This is the first of a two-part proceeding. Here, the agency has determined the appropriate methodology with which to measure each defendants' intrastate earnings. In separate orders issued today, the agency has directed each company to appear at a rate hearing at which the Commission will determine, using the methodology approved here, just and reasonable rates for each carrier.

This matter was heard on October 5, 1988 — Commissioners Frank Cochran, Keith Bissell, and Steve Hewlett presiding — and considered at a public conference on December 17, 1988. Based on the record developed at the hearing and the arguments and briefs of the parties, the Commission affirms the conclusions reached in the Show Cause Order concerning the appropriate method of setting intrastate rates for these carriers. In support of that decision, the Commission makes the following additional findings of fact and conclusions of law. 1/

I. Summary

The issue in this case is very simple. Federal law requires every telephone company to separate its expenses into interstate and intrastate portions. The four defendants in this proceeding are counting some expenses twice and charging them to both interstate and intrastate ratepayers. This practice is plainly illegal; the Commission will not tolerate it.

The four defendants accomplish this scheme by using one method to estimate their revenue requirements 2/ in Tennessee and a different method in the federal jurisdiction. These two methods, the "cost study" approach and the "average schedule" procedure, are both legitimate means of arriving at a company's jurisdictional revenue requirement. But each method produces a different result. When applied to the four defendants, the cost study approach allocates more expenses to intrastate ratepayers; the average schedules allocate more to the interstate jurisdiction. Therefore, to maximize its total profits, each company uses a cost study to determine its intrastate revenue requirement but uses the average schedules to estimate its interstate revenue requirement. As a result, some expenses are counted twice and recovered from ratepayers in both jurisdictions.

Double counting is illegal. As numerous courts and regulatory agencies have held, telephone costs must be apportioned uniformly between the state

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1/ In a decision announced February 7, 1989, the Wisconsin Public Service Commission reached the same conclusion that we adopt in this Order. Re: Mid-Plains Telephone, Inc., Docket 3650-DR-100. The agency has not yet released a written opinion.

2/ Unless noted otherwise, this Order uses the terms "revenue requirement," "costs," and "expenses" interchangeably to refer to all costs, including a reasonable rate of return, upon which a carrier's rates are based.

and federal jurisdictions. The total must equal 100%. No carrier can claim — as Alltel is doing — that 40% of its costs are interstate and that 80% are intrastate. No carrier is entitled to recover — as Alltel is doing — 120% of its total cost of providing service. Tr. 173-174, 180-181. 3/

The remedy in this case is also simple. The Federal Communications Commission (hereafter, the FCC) permits each defendant to use either a cost study or the average schedules to estimate its interstate revenue requirement. But whatever method is used in one jurisdiction must also be used in the other. Therefore, as long as any defendant uses the average schedules to estimate its interstate costs, this Commission must use a consistent approach to determine the company's intrastate costs.

The methodology approved here, often called "residual" ratemaking, accomplishes that result. Under this approach, the Commission calculates from each carrier's books its total unseparated costs of providing service — including the rates of return prescribed by state and federal regulators — and then subtracts the carrier's interstate revenue requirement. What remains — the "residual" — is the carrier's intrastate revenue requirement which will determine its intrastate rates. This approach ensures that the carrier cannot recover the same expenses twice; it has been used by state commissions for at least thirty years to determine the intrastate costs of "average schedule" telephone companies like the four defendants. 4/

3/ Crockett, Peoples, and West Tennessee telephone companies are earning, respectively, 108%, 121%, and 134% of their total costs from double counting expenses. Tr. 163.

4/ See Alltel Corp. v. FCC, 838 F.2d 551, 561 n.5 (D.C. Cir. 1988) which describes and implicitly approves residual ratemaking by state commissions. (The Alltel decision is discussed further at n.13, infra). See also Re: Loraine Telephone Co., 61 P.U.R.3d 443, 456 (Ohio P.U.C. 1965); and General Tel. Co. v. Ohio Bell, 39 P.U.R.3d 65 (Ohio P.U.C. 1961), aff'd. 184 N.E.2d 88 (1962), for a detailed discussion of residual ratemaking.

These conclusions, outlined in the Show Cause Order, are supported by testimony presented at the hearing by Mr. Dan McCormac of the Commission Staff and Mr. Richard Gabel, the author of Development of Separations Principles in the Telephone Industry (Michigan State University, 1967) and one of the nation's leading experts on the separation of interstate and intrastate costs for ratemaking purposes.

In response, the four defendants argue that federal law preempts Tennessee from adopting the residual approach in this proceeding. Their principal contention is that even though the FCC itself uses the average schedules to determine each carrier's interstate revenue requirement, FCC rules require Tennessee to use the carriers' cost studies to set intrastate rates. This and other arguments are discussed below.

II. Discussion

Separations, average schedules, cost studies, and the respective obligations of federal and state regulatory agencies are not — or should not be — subjects of dispute. These matters have been described in numerous judicial and administrative decisions on telephone ratemaking.

Unfortunately, the record in this proceeding is not so clear. To obscure the fact that they are double counting expenses, the four defendants presented testimony "intentionally confusing the basic issue in this proceeding." Tr. 291. To sort out the legal and ratemaking questions presented here, it is therefore necessary, as David Copperfield said, "to begin at the beginning."

A. Purpose of Separations and Need for Uniformity

The nation's telephone system is a unified whole; virtually all local telephone property is used jointly in the provision of both intrastate and interstate service "and is thus conceivably within the jurisdiction of both state and federal authorities." Louisiana Public Service Commission v. FCC, 476 U.S. 355, 90 L.Ed.2d 369, 376 (1986). Congress, in other words, could entirely preempt all state regulation of telephone service. Id. Instead, Congress created a dual regulatory system, authorizing the Federal Communications Commission to regulate "interstate and foreign" telephone service while expressly reserving to the states jurisdiction over intrastate service. Louisiana, 90 L.Ed 2d at 376, 379-380; 47 U.S.C.A. § 152(b).

To effectuate this division of responsibility, the Federal Communications Act provides for the "separation" of all telephone property into interstate or intrastate portions. Louisiana, 90 L.Ed.2d, at 386. All the costs of operating a local exchange telephone system — such as taxes, plant investment, and operating expenses — must be assigned either to the federal or state jurisdiction before either can begin setting rates to cover those costs. Separations, in other words, is not merely an accounting exercise; it is an "essential" step in the calculation of constitutionally sufficient rates by federal or state regulators. Smith v. Illinois Bell, 282 U.S. 133, 148, 75 L.Ed. 252, 263 (1930). 5/

This is a basic principle of ratemaking. Rates are set to reimburse a carrier for its total costs of providing service, its "revenue requirement." Thus, the first step in this and every rate case is to measure a carrier's

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5/ The Constitution requires that rates provide a utility owner a fair return on his investment; the value of that investment is determined by what portion is allocated to the ratemaking jurisdiction. Simpson v. Shepard, (Minnesota rate cases), 230 U.S. 352, 57 L.Ed. 1511, 1555 (1913); Smyth v. Ames, 169 U.S. 466, 42 L.Ed 819, 849 (1898). Therefore, the determination of a company's separated costs is a necessary prerequisite of the ratemaking process. Charles Phillips, Jr., The Regulation of Public Utilities, 305-316, (1988); Louisiana, 90 L.Ed.2d at 379; Comm. Teleph. Co. v. Wisconsin P.S.C., 71 P.U.R. (NS) 65 (1947), aff'd, 32 N.W.2d 247 (Wisc. 1948).

total costs and divide them between the state and federal jurisdictions. The separations process dictates how these costs are divided and, therefore, ultimately determines the price of every telephone call. State Corporation Comm. of Kansas v. FCC, 787 F.2d 1421, 1426 (10th Cir. 1986); Rural Telephone Coalition v. FCC, 838 F.2d 1307, 1310 (D.C. Cir. 1988).

There is no "purely economic method" of separating telephone plant that is used jointly in both intrastate and interstate communications. MCI v. FCC, 675 F.2d 408, 415-416 (D.C. Cir. 1982). Therefore, any separations process necessarily requires subjective judgments reflecting "policy choices that are not constitutionally prescribed." Id. 6/

But whatever separations policies are adopted by one jurisdiction must also be followed by the other. Otherwise some costs of providing telephone service may be allocated to both jurisdictions or to neither. Uniformity in the separations process is therefore both an equitable goal and a legal necessity. As the FCC said more than twenty years ago,

> "[A] fundamental principle to be observed in making jurisdictional separations is the need for uniformity in the procedures applied by both federal and state authorities for ratemaking purposes. We subscribe fully to this objective as we have in the past. Such uniformity obviates the danger that certain amounts of plant investment and expenses may be assigned to more than one jurisdiction to the detriment of ratepayers. Equally important, it obviates the risk that certain amounts of plant and expenses will be recognized in neither jurisdiction to the economic detriment of the company and its owners.

Re: AT&T, 70 P.U.R.3d 129, 199 (1967).

6/ See also Re: Intrastate and Interstate Operations of Telephone Companies, 78 P.U.R.3d 479, 496-497 (FCC, 1969) (Johnson, dissenting, explaining that "separations is an inherently arbitrary undertaking").

Uniformity in the separations process ensures that carriers and customers are treated fairly. All costs must be allocated to one jurisdiction or the other; none to both. Thus, there is a reciprocal, inverse relationship between a carrier's interstate and intrastate costs. One cannot change without affecting the other, as many courts and agencies have explained.

Separations for interstate ratemaking and separations for intrastate ratemaking "are two sides of the same coin." Hawaiian Telephone v. P.U.C. of Hawaii, 827 F.2d 1264, 1275 (9th Cir. 1987). The "sum of the intrastate and interstate portions for rate base allocation purposes" must equal "100%" of the telephone company's total (unseparated) costs. Id. As one state commission put it, "Tersely stated, it [separations] presupposes that 'the sum of the parts must equal the whole.'" Re: New England Tel. & Telegraph Co., 21 P.U.R.3d 195, 198 (New Hampshire P.U.C. 1957). 7/ Thus, if the FCC "declares its rate base to include certain costs, these costs are not used in determining a state's rate base." Senate Report No. 362 at 3, 1971 U.S. Code Cong. and Admin. News at 1513. Conversely, "if the interstate portion of unseparated costs is found to be lower, the intrastate portion (which is the difference between unseparated cost and interstate cost) will be higher." Alltel Corp. v. FCC, 838 F.2d at 561 n.5.

Simply put, whatever costs are used to fix rates in one jurisdiction may not also be charged to customers in the other jurisdiction. If a carrier's total expenses, including a rate of return, are $100, and the FCC sets rates which are intended to cover one-fourth ($25) of those costs, the

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7/ See also Application of Hawaiian Tel. Co., 689 P.2d 741, 751-752 (Haw. 1984) quoting New England Public Utilities Comm., 448 A.2d 272, 288 (Me. 1982); and "Separation of Company Property for Intrastate Telephone Rate Regulation," 54 Colum. L. Rev. 431 (1954) (explaining the reciprocal nature of, and the need for consistency in, the separations process).

remaining expenses ($75) must be allocated to intrastate ratepayers. If the interstate revenue requirement is reduced to $20, the state share must be increased to $80. Tr. 165-167.[8/]

B. Cost Studies and Average Schedules

In recognition of the need for uniformity in the allocation process, Congress has granted the FCC plenary jurisdiction to prescribe separations procedures which are binding on all state regulatory commissions. Kansas, 787 F.2d at 1425-1428. Federal preemption is necessary "because a nationwide telecommunications system with dual intrastate and interstate rates can operate effectively only if one set of separations procedures is employed." Hawaiian, 827 F.2d at 1274-1276. See 47 U.S.C. § 221(c) (authorizing the FCC to classify property used for interstate and foreign telephone service).[9/]

Pursuant to its statutory mandate, the FCC has established elaborate procedures, described in Part 36 of the agency's rules, to estimate the interstate portion of each carrier's costs. NARUC, 737 F.2d at 1105; Alltel, 838 F.2d at 553. This process, described as a "cost study," requires "extensive data collection, reporting and auditing." NARUC, 737 F.2d at 1127.

8/ Thus, all ratemaking is "residual" in the sense that any costs not allocated to one jurisdiction must be allocated to the other. The term, however, is generally used only to describe the process of setting intrastate rates for carriers that use the federal average schedules to estimate their interstate costs.

9/ Since separations decisions affect both interstate and intrastate rates, the Federal Communications Act also provides that separations issues first be considered by a federal-state joint board before being presented to the FCC. Reservation Telephone Co-op v. FCC, 826 F.2d 1129, 1132 (D.C. Cir. 1987); see 47 U.S.C. § 410(c).

These cost studies, however, can be a "difficult and costly burden for small telephone companies." Therefore, the FCC allows smaller exchange carriers "to estimate some or all of their costs through use of an 'average schedule' which adopts generalized industry data to reflect the costs of a hypothetical exchange company." Id. at 1095; quoted in Alltel, 838 F.2d at 553; and in City of Brookings Minn. Tel. Co. v. FCC., 822 F.2d 1153, 1157 (D.C. Cir. 1987).

In other words, just as the Internal Revenue Service permits a taxpayer to determine his deductible expenses either by itemizing each cost or by adopting the "average" (standard) deduction, the FCC allows small exchange carriers to compute their interstate costs either by conducting lengthy cost studies or by adopting the average cost figures of comparable carriers.

More than half of the nation's 1500 local exchange carriers (tr. 102, 291) use the average schedules "as a means of approximating" their separated, interstate costs. MTS & WATS Market Structure (Reconsideration Order), 97 F.C.C.2d 682, 760 (1983). Developed from data provided by comparable "cost study" companies, the average schedules estimate all the separated costs, including a return on investment, of providing interstate telephone service. The FCC then approves interstate rates designed to produce sufficient revenue to pay each "average schedule" carrier an amount equal to its "costs" as calculated by using the schedules. 10/ Since the

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10/ The agency does not actually set rates for every individual carrier under its jurisdiction. In sum, all local carriers charge the same interstate rates (access charges) and deposit their interstate revenue in a nationwide fund, called a "pool," administered by the National Exchange Carrier Association (NECA). Each carrier then estimates its costs of providing interstate service, including the FCC-prescribed rate-of-return, and withdraws that amount from the pool. A carrier can estimate its costs either by performing a cost study or by using the average schedules. NECA annually reviews pool revenues and disbursements and recommends to the FCC (Continued on next page).

schedules reflect cost-study data from typical small-sized carriers, payments (called "settlements") made to an average schedule carrier "simulate the compensation that would be received by a cost company." MTS & WATS Market Structure: Average Schedule Companies, 103 F.C.C.2d 1017, 1020 (1986); Brookings, 822 F.2d at 1158, 1165-1166; 47 C.F.R. § 69.606(a).

The key point in the discussion is the relationship between cost studies and average schedules and how each approach influences both interstate and intrastate rates.

Under the cost approach, a carrier calculates its revenue requirement by conducting a cost study to divide its property, expenses, and taxes between the intrastate and interstate jurisdictions. State and federal regulators then determine independently what costs may be recovered from ratepayers and what return the carrier should earn. The end result is the carrier's revenue requirement — the gross revenue which the company requires to provide service in that jurisdiction. The carrier's rates are designed to generate that amount.

The average schedules are derived from data provided by cost study carriers and reflect the average costs, per customer and per call, of

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any necessary changes in the level of interstate access charges to keep all pool members whole. Should there be any excess or shortfall in the pool, it is shared by all participating carriers. Tr. 44, 103-104, 232-234; see Brookings, 822 F.2d at 1157-1161.

The pooling mechanism is used to promote uniform, nationwide toll rates. See GTE Service Corp. v. FCC, 782 F.2d 263, 266-267 (D.C. Cir. 1988). The pool permits all participants to charge the same rates for interstate access but ensures that each carrier receives revenue payments equal to its interstate revenue requirement. See n. 11, infra.

providing interstate telephone service. The schedules include all costs, including the federally prescribed rate of return, so that the end result — the calculation of the carrier's interstate revenue requirement — will approximate the result arrived at through the cost study method. See pp. 8-11, infra. 11/

Thus, both average schedules and cost studies are means of arriving at the same end: the estimation of a carrier's interstate revenue requirement based on its separated costs. One approach uses a company's actual expenses; the other relies on cost data from comparable companies. But whichever method a carrier chooses, the resulting cost estimate necessarily determines both the carrier's interstate and intrastate rates. As discussed earlier, the separations process is a reciprocal one. All expenses must be allocated to one jurisdiction or the other. Once the FCC has estimated a carrier's interstate costs and approved rates to cover those costs, whatever expenses remain automatically fall to the intrastate jurisdiction. This is a basic principle of regulation and the heart of the matter before us.

11/ For example, an average schedule carrier receives $8.06 a month per access line to compensate the company for the non-traffic-sensitive (NTS) portion of its interstate costs. Brookings, 822 F.2d at 1158-1159, n.10. That figure includes a 12% return which the FCC has determined to be a "just and reasonable" profit for the interstate investment of local exchange carriers. Tr. 166, 254; Authorized Rate of Return for Interstate Services of AT&T and Exchange Telephone Carriers, 50 Fed. Reg. 41350 (1985), reconsid. denied, FCC No. 86-544 (Jan. 14, 1987). The company, however, may at any time elect to become a "cost study" carrier, calculate its own NTS costs, separate the interstate portion, add a 12% return, and collect revenue to cover the result. Since $8.06 is an average figure, presumably some carriers would gain revenue while others would lose by switching from average schedules to cost studies. Under either the cost study or average schedule approach, a carrier's revenue may fluctuate slightly as the result of any excess or shortfall in the access charge pool. N.10, supra.

To illustrate this point clearly, we present the following, simplified example:

Smith owns a coin telephone booth. According to his records, the total, annual expenses of operating the booth are $100 including depreciation, taxes, and a reasonable return on investment. Customers use the telephone to make both interstate and intrastate calls. How does Smith fix rates?

Because of our dual regulatory system, Smith's first task is to divide the $100 into two portions — interstate and intrastate — based on customer usage. He will then design two sets of rates — federal and state — to cover the expenses assigned to each jurisdiction.

The Federal Communications Commission supervises the allocation process and has approved two procedures for dividing Smith's interstate and intrastate expenses. Smith can choose either approach.

The first, the cost study method, requires Smith to conduct a study of all calls made from his booth during a representative period. From the study, Smith determines that 20% of the calls are interstate. He therefore allocates $20 of expenses to the interstate jurisdiction and $80 to the intrastate side. These dollars represent Smith's "revenue requirement" and, thus, determine his rates in each jurisdiction. For interstate calls, Smith sets rates at a level which he estimates will generate $20 in annual revenue. In the state jurisdiction, he designs rates to collect $80 from intrastate customers.

The second approach, the average schedule method, allows Smith to fix rates without conducting a study. Based on data collected from studies of other telephone booths, the FCC has determined that the average cost of providing interstate service from a booth like Smith's is $40 a year. To save Smith the time and expense of counting calls, the FCC allows him to assume that his interstate expenses are equal to the industry average. Under this approach, in other words, Smith estimates that his interstate revenue requirement is $40, regardless of what his actual costs may be, and he sets rates intended to collect that amount from interstate customers. To set state rates, Smith deducts $40 from the total costs shown on his account books and allocates the "residual" — $60 — to intrastate customers.

The problem is that Smith has mixed together the average schedule and cost methods in order to charge customers for $20 of "costs" that don't exist. Using the average schedule approach, he has assumed that his interstate costs are $40 a year and fixed rates accordingly. But, at the same time, he has used the cost study approach to allocate $80 of expenses to the intrastate jurisdiction. Smith, in short, is cheating his customers by allocating $40 of expenses to one jurisdiction and $80 to the other; he is collecting rates designed to generate $120 in total revenue, $20 more than the actual costs of operating the booth.

No carrier has the right to manipulate the separations process in this manner. If Smith uses the average schedule approach and assumes that his interstate revenue requirement is $40, he must subtract that amount from the $100 of actual costs recorded on his books. What remains — $60, not $80 — is Smith's intrastate revenue requirement.

Rates must be based on costs. Smith's costs are recorded in his books. No matter what method he uses to allocate those costs for ratemaking purposes, the total assigned to both jurisdictions cannot be more than $100. That is the basis of this Order.

C. The Defendants

The defendants are all average schedule carriers for purposes of interstate ratemaking. Because of their small size, the defendants are presumed "not to have sufficient financial resources or expertise to justify a requirement" that they perform cost studies. MTS and WATS Market Structures: Average Schedule Companies, 103 F.C.C.2d 1017, 1018 (1986). Despite that presumption, all four defendants have conducted, or intend to conduct, full-blown cost studies which they propose to submit to this Commission but not to the FCC.

No one disputes the Staff's evidence that the defendants' studies allocate less cost to the interstate jurisdiction (and thus more cost to Tennessee) than the average allocation built into the schedules. See tr. 85-86, 322.

For example, Alltel's cost study allocates about 17% of the carrier's non-traffic-sensitive (NTS) plant to the interstate jurisdiction and 83% to Tennessee. The average schedules, however, reflect the industry average which is 26% interstate and 74% intrastate. See NARUC, 737 F.2d at 1105. Thus Alltel is double counting 9% of its NTS costs alone and, if we adopt the defendants' proposal, will recover these expenses twice. Tr. 254-255.

Despite that evidence and the carriers' acknowledgment that Tennessee has the right to assure itself that "100% of the companies' expenses, revenues, taxes, and investments are separated correctly into the respective jurisdictions" (tr. 109), the defendants insist that the Commission is "required" by federal law to set intrastate rates based on the results of their cost studies regardless of what costs have been allocated to the federal jurisdiction. Tr. 134.

In support of their position, the defendants make the following arguments: (1) Federal law preempts state authority to use the residual approach when actual cost study data is available; (2) application of the residual method unreasonably discriminates against the four defendants; and (3) the Commission is bound by its decision eight years ago when it used a cost study to set rates for Alltel. We will now consider each point.

D. Federal Preemption

Although couched in several different ways, the defendants' main argument in this proceeding is a federal preemption claim that turns the principle of uniformity -- and the whole purpose of the preemption rule -- on its head.

Their argument runs as follows: the FCC has preempted state authority in the area of separations; the FCC's rules regarding the separation of interstate and intrastate property are found in Part 36 (47 C.F.R. § 36 et seq.); the average schedules are not mentioned in Part 36; states are therefore preempted from using the average schedules as a surrogate for Part 36 cost-study data. To support this logic, the defendants' cite Hawaiian Telephone, 827 F.2d 1264, which holds that states may not adopt separations procedures which are inconsistent with Part 36. Defendants' Initial Brief, 10, 14; Reply Brief, 4-5, 7.

The defendants' preemption argument is factually misleading and logically backwards.

The fact that the schedules are not mentioned in Part 36, which describes the FCC's cost study procedures, has no particular significance. The schedules are referred to in Part 69 which describes how carriers are reimbursed for their interstate costs and specifically states that payments to average schedule carriers must "simulate the disbursements that would be received" by a comparably sized carrier which had separated its costs in accordance with Part 36. 47 C.F.R. § 69.606(a). In other words, the rules require that the average schedules approximate "the interstate costs that would be computed under the applicable Separations Manual formula [Part 36]." MTS and WATS Market Structure, 97 F.C.C.2d at 760. To accomplish that result, the schedules are derived from cost study results (see discussion at pp. 9-10, supra) and are periodically adjusted to reflect changes in the way studies are conducted.12/ Brookings, 822 F.2d at 1158. It is therefore irrelevant that the schedules are not described in Part 36 itself.

More importantly, the defendants' preemption argument is inconsistent with the whole purpose of the preemption requirement. As the Hawaiian court, the FCC, and others have explained (see discussion at pp. 6-7, supra), the reason for federal preemption in the separations field is to ensure that federal and state regulators follow uniform allocation procedures. It is the only way to make sure that all costs are counted once — but only once — in the separations process.

Here, the defendants invoke the preemption doctrine hoping to accomplish just the opposite result. They contend that even though the FCC itself uses the average schedules to separate costs, FCC rules prohibit Tennessee from following the same approach. Even though this mismatch results in allocating 40% of a carrier's costs to one jurisdiction and 80% to the other, they argue that Tennessee must adhere strictly to Part 36 in

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12/ For this reason, the defendants' arguments that residual ratemaking is illegal because it (a) ignores the "actual usage" test (defendants' Initial Brief, 15) and (b) has not been approved by a federal-state joint board (see n.9, supra; defendants' Reply Brief, 6) are without merit since whatever criteria are used in Part 36 are necessarily reflected in the average schedules.

determining each defendant's intrastate costs. It is not surprising that the defendants cite no authority holding that the FCC has ever supported — or would ever support — such an anomalous application of the preemption rule.

The defendant's insistence that this Commission follow the cost study approach exalts procedure over principle. It is not particularly important what procedure one chooses to separate costs. What matters more is the "fundamental principle" that regulators in both jurisdictions follow a uniform approach. AT&T, 70 P.U.R.3d at 199. The defendants' preemption argument disregards the need for uniformity in the separations process and creates a regulatory system in which the sum of the parts is more than the whole. To justify this result, the defendants offer two explanations.

First, they claim that the average schedules calculate revenue, not costs. The schedules are a "revenue distribution mechanism" (tr. 110) which "is not related to the separations process." Tr. 107, 110; Reply Brief, 6, 7. Acknowledging that their settlement payments exceed the interstate revenue they would receive under the cost approach, the defendants explain that this difference represents interstate "earnings" in excess of their "actual" interstate costs. Tr. 109; Initial Brief, 6-7; Reply Brief, 15. To illustrate their argument, they describe a carrier which has an "interstate revenue requirement" of $400 but receives $500 in "interstate revenue." Reply Brief, 9. Only the FCC, they claim, has the power to correct this "revenue/cost imbalance" by either reducing the average schedule settlements (see Brookings, 822 F.2d 1153) or by requiring the defendants to switch to the cost approach in the interstate jurisdiction. See Alltel, 838 F.2d

551.[13/]

This characterization of the average schedules is clearly wrong. Tr. 268. As the FCC, the courts, and even the defendants' own witnesses and lawyers have repeatedly stated, the schedules determine costs, not revenues. See discussion at pp. 8-13, supra.[14/] The schedules estimate each

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13/ In that case, Alltel Telephone, Inc. (the parent company of Alltel Tennessee, Inc.) successfully overturned an FCC rule which would have required Alltel to use cost studies instead of the average schedules to calculate the interstate revenue requirement of each subsidiary company. During oral argument, Alltel's lawyer, Mr. David Poe, told the Court that even if a carrier's average schedule settlements were too high, these interstate revenues helped keep intrastate rates down because of "residual" ratemaking by the states. For example:

Question from the Court:	Then what happens, Mr. Poe, with respect to local regulation? There was some discussion of the fact that if you lowered the cost recoverable on the interstate [word], you would have to make up for that on intrastate business?
Mr. Poe:	That is correct, your Honor...[T]he way in which local regulators set rates for these companies is that they look at the total level of (settlement), in other words, total number of revenues that the company has. They have an idea of the company's total costs, and they simply credit back the revenues on the interstate side. So its a residual kind of thing...So that intrastate rates are lower, concomitantly, by virtue of the fact that interstate rates are higher.

The Court accepted Mr. Poe's explanation and cited — with implicit approval — state use of residual ratemaking as one of the reasons for ruling against the FCC in that case. 838 F.2d at 561, n.5.

But in Tennessee, Ohio, Pennsylvania, and Kentucky, Alltel does not set rates in the manner described by Mr. Poe. Furthermore, as discussed above, the company's position here is that residual ratemaking is illegal. In the Tennessee hearing, Mr. Poe was asked why he had failed to inform the Court of this information. He answered, "I was not called upon by the Court to address that issue, and therefore I didn't." Tr. 315-316.

14/ Alltel's witness Will Staggs testified several times that his company's average schedule settlement "represent[s] a proxy of Alltel Tennessee's interstate toll costs as defined by the FCC." Tr. 45, 46, 47, 55. Even Alltel's lawyers have described the average schedule mechanism as a "shorthand method of cost calculation." Brief of Alltel Corporation in Alltel v. FCC, 838 F.2d 551, p.24.

defendant's interstate revenue requirement -- expenses plus a return component -- and therefore determine what rates are charged to interstate customers. Whether the rates generate "excess" earnings depends upon what costs the rates are designed to cover. For an average schedule carrier, interstate costs and revenues are equal. The schedules estimate costs; the costs determine rates; and the rates produce revenue to pay each carrier an amount equal to its estimated costs. See discussion at p.9, supra, and n.20, infra. There are no excess interstate earnings. Tr.174. 15/

Their description of a carrier which earns $100 more than its interstate revenue requirement reflects the defendants' confusion. The example has nothing to do with this case. As one of their own witnesses testified, each defendant is earning "exactly" its interstate revenue requirement. Tr. 62. The issue here is not about excess interstate revenues or a "revenue/cost imbalance"; it's about revenue requirements and an imbalance in the separation of costs between the federal and state jurisdictions.

The defendants' second explanation of double counting is that a carrier's revenue requirement in Tennessee has nothing to do with its revenue requirement in the federal jurisdiction. According to the defendants, the only way to determine a company's total costs is to calculate the intrastate and interstate portions independently and then add them together. Tr. 55, 60, 128. As Mr. Staggs said, Alltel's total costs "may be said to be the sum of its interstate toll settlements and its

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15/ In a recent letter to the Tennessee Staff, the head of the FCC's Common Carrier Bureau explained, "An average schedule company that is properly receiving interstate settlements pursuant to the average schedules that were approved by the Commission is not, as a matter of law, receiving excessive interstate settlements or excessive interstate earnings." Letter from Gerald Brock to Henry Walker, dated December 2, 1988. Late-filed Exhibit.

separated, interstate costs determined by conducting ... a Part 36 study." Tr. 48.

This reasoning, of course, is inconsistent with the first argument that the schedules cannot be used to define costs. More importantly, this argument does not address the problem of double counting; it simply defines it away. If each jurisdiction determines costs without regard to the other, the principle of uniformity is meaningless.

Implicit in both these arguments is the notion that the defendants' "actual" costs can only be determined by conducting a cost study and that the average schedule estimates are merely "hypothetical" figures to which the normal rules of ratemaking — such as uniformity in the separations process — do not apply. See tr. 129.

Obviously, the average schedules are just that -- average -- and do not produce the same cost estimate for any carrier that a Part 36 study would produce. But once that estimate is translated into customer rates, no one cares whether it represents "actual" costs or "hypothetical" costs. It's all the same to the customer who pays the bill.

What the defendants do not understand, or refuse to recognize, is that the only "actual" costs incurred by a carrier are the expenses recorded on its account books. 16/ Once a portion of those costs has been allocated to

16/ In his direct testimony, defense witness Mr. Robert Schoonmaker argued that it is impossible to calculate accurately a carrier's total costs from the figures shown on the company's books because of the fact that federal and state regulators follow different policies in determining a carrier's revenue requirement. For example, the FCC has prescribed a 12% rate-of-return for each defendant which is higher that the return prescribed by the Tennessee Commission.

Under the residual approach, a state regulator should take these differences into account in calculating a carrier's total, unseparated revenue requirement; otherwise the residual allocation to the state jurisdiction will be inaccurate. Tr. 170-171. The Staff witnesses testified (Continued on next page).

the interstate jurisdiction — whether by conducting a study or using a hypothetical, industry average — that amount must be deducted from the total costs shown on the books. The remaining expenses are automatically assigned to the intrastate jurisdiction. 17/

The purpose of ratemaking is to set rates to cover costs. Those costs are not pulled from the air; they are recorded in the carrier's books. 18/ Tr. 180. No matter how these costs are divided between the state and

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that they had made — or would make — compensating adjustments in order to account for differences in the rate-of-return and in the regulation of billing and collection services. Tr. 163-168, 179-180 (rate-of-return difference); tr. 177-178, 289-290 (billing and collection difference). The witnesses noted, however, that these differences are relatively insignificant in light of the overall impact of double counting.

After the hearing, the defendants apparently dropped this argument. It is not mentioned in their Initial Brief or their Reply Brief.

17/ Alltel's lawyer David Poe understood this point very well when he explained residual ratemaking to the U.S. Court of Appeals (see n.13, supra):

> They [state regulators] have in front of them sufficient information to determine the company's total cost because the information is required to be reported to state regulators...A separation study is done with respect to whether or not they're interstate or intrastate costs at some point. But what the local regulator has in front of him are the real costs of the company... Real costs, real dollars. And the issue that we're examining here is whether or not the appropriate division is being made here, and instead of making a precise division between inter and intrastate, what is happening is that the local regulator is saying, well, we know you're getting revenues over here, and we know what your total costs are, so we can determine what more you need to get on the intrastate side in order to have a reasonable rate of return.

Transcript of Oral Argument, 10.

18/ To ensure that the books are accurate, state commissions prescribe uniform accounting procedures for regulated carriers and conduct periodic audits to monitor compliance. See T.C.A. § 65-4-111.

federal jurisdictions, regardless of whether one jurisdiction is favored over the other, the sum of a carrier's interstate and intrastate revenue requirements cannot be more than the actual costs shown on the carrier's books. Tr. 167. No carrier has the right to charge customers for expenses that don't exist.

This Commission cannot redesign the average schedules or tell the FCC how to determine the defendants' interstate rates. But it has both the right and the duty to prevent carriers from creating phony "costs" by assigning some expenses to both jurisdictions.

For example, the District of Columbia Public Service Commission discovered during a rate case that the local telephone company had "mistakenly" allocated to the interstate jurisdiction a portion of the carrier's costs which, according to FCC rules, properly belonged in the intrastate jurisdiction. Re: The Chesapeake and Potomac Telephone Company, 4 P.U.R.4th, 1 (1974). The FCC, however, had already incorporated those costs into the company's interstate revenue requirement and approved rates to pay for them.

The company argued that, despite the error, the federally prescribed Separations Manual required the D.C. Commission to include those same costs in the carrier's intrastate revenue requirement.

The Commission properly refused to make ratepayers pay twice for the same services. "There is no justification for burdening both the intrastate and the interstate users" with the same costs, the agency wrote (at 10), explaining that its decision was "consistent with the uniformity principle" (at 13) which is the underlying purpose of the separations process. The

Commission concluded,

> The [Separations] Manual is based upon an objective of uniformity of allocation, to insure that the investment and expenses of the telephone system are included in either an interstate or intrastate operations — but included only in one. Since the investment and expenses have been recognized by the FCC in fixing interstate rates, their recognition here again in fixing intrastate rates would violate the principle of single allocation underlying the Manual.

Id. at 10.

The issue is the same here. Measured by Part 36, the defendants' average schedule settlements are too high. But that "mistake" does not justify double counting. Even though the schedules assign some expenses to the interstate jurisdiction which, according to Part 36, should be assigned to Tennessee, a carrier cannot recover those expenses twice by also including them in its intrastate revenue requirement. Whatever costs are built into a carrier's interstate rates, whether by accident or design, cannot also be built into state rates. To prevent that, the carrier's interstate revenue requirement must be deducted from the total expenses shown on the carrier's books. Otherwise, the "mistake" would be counted and recovered twice — which is, of course, exactly what the defendants propose to do.

Finally, we note that state use of the residual approach has been approved in both judicial and administrative decisions including the Alltel opinion last year and the recent decision of the Wisconsin Public Service Commission in a case identical to the present proceeding. See n.1 and n.4, supra.

The FCC, moreover, has been informed of the double counting problem by the National Association of Regulatory Utility Commissioners (NARUC). According to a NARUC staff report on the matter, the FCC's "current position" is that "this issue involves intrastate ratemaking which is within the sole discretion and jurisdiction of the states." The report said the FCC indicated it would "not prevent the states from continuing to use a residual or total company approach for exchange carriers using interstate average schedules" whether or not the carrier had conducted a cost study. 19/

The defendants, on the other hand, have not cited a single judicial or administrative decision holding that federal law requires Tennessee to accept the defendants' intrastate cost studies or otherwise questioning the legality of residual ratemaking.

For these reasons, we reject the defendants' preemption argument.

19/ Last year, the NARUC adopted a resolution raising the double counting issue and referring the matter to a federal-state joint board for consideration. Tr. 204-205. Following an investigation, the staff of the joint board reported back to the NARUC that, according to FCC representatives, the federal agency had reviewed the matter and determined that a state's decision whether or not to accept a carrier's cost study or to follow the residual approach was purely a local matter not subject to federal interference.

During its investigation, the joint board staff convened a meeting on the issue with representatives of the FCC, interested states, AT&T and several exchange-carrier trade associations. The report said, "The consensus of those attending the meeting was that it is not appropriate for exchange carriers to use the average schedules for interstate purposes and then use costs studies for intrastate purposes in order to recover more than 100% of the Company's total cost... Everyone in attendance agreed that Alltel, et al.'s, argument has no equitable basis."

Upon receiving the staff report, the NARUC adopted a second resolution stating that states could use the residual approach to prevent the double counting of costs and that the FCC had no opinion on the matter. The resolution commended the joint board staff for their satisfactory resolution of the problem and directed that copies of the staff report be sent to all state commissions.

The appendix to this Order contains copies of the second resolution and the report of the joint-board staff.

E. Equal Protection

The defendants claim that the Commission cannot set the rates of an average schedule company in a different manner than a cost company. Defendants' Initial Brief, 15-17. They argue that the Equal Protection Clause of the U.S. Constitution requires the Commission to treat all exchange carriers the same without regard to how those carriers are regulated by the FCC. Id.

Like the carriers' preemption argument, this claim misses the whole point of the need for uniformity in the separations process. No carrier is entitled to allocate the same property to both the federal and state jurisdictions. The only way to prevent that from happening is for both jurisdictions to adopt consistent allocation procedures. If and when the defendants file their cost studies with the FCC, the Tennessee Commission will use those studies to set intrastate rates. 20/ But as long as the defendants use the average schedules to determine their interstate revenue requirements, Tennessee must also use the schedules to fix the defendants'

20/ In fact, the Commission could also use the residual approach to set rates for cost study carriers. The result would be no different than using the cost approach. For example, one could determine South Central Bell's intrastate costs by calculating the company's total revenue requirement and then subtracting its interstate revenue requirement. Since Bell's interstate costs are derived from a cost study, the "residual" costs allocated to Tennessee would also reflect the results of that study. The result, therefore, would be no different than if Tennessee had used Bell's study in the first place to determine the carrier's intrastate costs.

(Note that, under the residual approach, one subtracts from total costs the carrier's interstate revenue requirement, not its interstate revenue. For average schedule carriers like the defendants, this distinction is not important. Because of the interstate pooling arrangement, each carrier's settlement payments equal exactly its interstate revenue requirement. See n.10, supra. For a carrier like Bell, however, which is not a full participant in the pool, there may be a difference between its interstate revenue and its revenue requirement.)

intrastate costs. 21/

F. Commission Precedent

Finally, Alltel alone argues that since the Commission accepted the company's cost study in its last rate case eight years ago, (Docket U-6940), it is obliged to do the same here absent a "change of circumstances." Defendants' Initial Brief, 8-9.

No one challenged Alltel's cost study in the earlier case -- which itself was a departure from the residual methodology the company had used in the past -- and none of the testimony and arguments presented here were raised by any party. To the extent our decision in that case could be considered agency policy, the discussion here provides ample explanation why that policy should now be changed. 22/

III. Conclusion

Like every state regulatory commission, Tennessee has the obligation to insure that any carrier under its jurisdiction has fairly allocated its total expenses between state and interstate ratepayers. The Commission finds that each defendant allocates a portion of its expenses to the

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21/ As explained in the Show Cause Order (at 4, n.4) the regulatory approach recommended by the Staff in this case is the same method used to set rates for the other, eight, average-schedule companies under the Commission's jurisdiction. One of those eight, Tellico Telephone Company, has also conducted cost studies but has agreed not to use the studies for intrastate ratemaking purposes as long as the company remains an average schedule carrier. Tr. 164.

22/ For a discussion of stare decisis in the administrative context, see Pinellas Broadcasting Co. v. F.C.C., 230 F.2d 204, 206 (D.C. Cir.), cert. denied, 350 U.S. 1007 (1956), Prettyman, J. "The Commission's view of what is best in the public interest may change from time to time. Commissions themselves change, underlying philosophies differ and experience often dictates change." See also Greater Boston Television v. F.C.C., 444 F.2d 841, 852 (D.C. Cir. 1970) cert. denied, 403 U.S. 923, Leventhal, J.

interstate jurisdiction equal to the amount of the carrier's average schedule settlement. Therefore, that amount should be separated from the total costs shown on the carrier's books in order to arrive at the carrier's intrastate revenue requirement. In determining a carrier's total costs, the Commission will make appropriate adjustments to compensate for any difference between federal and state ratemaking policies, such as differences in the prescribed rates-of-return, which would affect the carrier's total revenue requirement. <u>See</u> n.16, <u>infra</u>.

IT IS THEREFORE ORDERED:

1. That in fixing rates for these defendants, the Commission will use the residual ratemaking approach described in this Order and;

2. That financial reports filed by the defendants with the Commission shall be made consistent with this approach;

3. That any party aggrieved with the Commission's decision in this matter may file a Petition for Reconsideration with the Commission within ten (10) days from and after the date of this Order;

4. That any party aggrieved with the Commission's decision in this matter has the right of judicial review by filing a Petition for Review in the Tennessee Court of Appeals, Middle Section, within sixty (60) days from and after the date of this Order.

CHAIRMAN

COMMISSIONER

COMMISSIONER

ATTEST

EXECUTIVE DIRECTOR